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Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

21 August 1989

EASTERN EUROPE-USSR: FORGING ECONOMIC INTEGRATION WITH "DIRECT LINKS"--MORE SMOKE THAN FIRE

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Summary

Western efforts to encourage the East European regimes to reorient their economies towards the West and adopt meaningful market-oriented reforms must contend with the Soviet campaign to bend ongoing reforms toward integration of the bloc economies. This campaign to relax state control of intra-bloc trade by forming direct links between enterprises echoes Western calls to expose planned economies to market forces, but it also carries political and economic overtones that might compromise East European national sovereignty and distort independent economic reforms. Deeper ties between the Soviet and East European economies--especially if motivated more by Moscow's desire to shore up its role as regional leader than by mutual interest in trade reform--would undermine US interests in increased East European independence from the USSR.

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Working to the US's advantage, however, is East European skepticism about closer economic integration through direct links and general confusion over how to reconcile central planning with domestic and CEMA trade reforms. Soviet leader Gorbachev wants to improve

This typescript was prepared by Office of European Analysis. Comments and queries are welcome and may be directed to the Chief, East European Division, EURA, 25X1 25X1

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coordination of economic policies at the state-to-state level, but this aim is somewhat at odds with his insistence that emphasis be placed on creating economic incentives for direct links between enterprises in different countries in order to enhance the efficiency of trade and strengthen mutual advantage in cooperation. [redacted] 25X1

The direct links campaign will not produce a more integrated Soviet economic bloc unless more regimes agree to introduce coordinated reforms to make their economies more compatible, prices realistic, and currencies convertible. At present, some countries are ahead of others with such reforms that are intended to build stronger trade links with the West. Wariness of Moscow's motives will lead most regimes to look for ways to retain firm national control over domestic and foreign economic policies. Meanwhile, enterprise managers have few economic incentives to form direct links with the East and tend to resort to pro forma "paper" ventures to placate political leaders eager to tout their commitment to CEMA integration. When enterprises do display initiative in developing producer-level cooperation, the foreign trade bureaucracies often retain enough power to hobble efforts and undercut their interests. [redacted] 25X1

The outcome of the newest strategy on CEMA integration will help shape future East-West relations. If successful, the initiative could complicate US efforts to encourage the East Europeans to dismantle their command economies and rebuild economic and political ties with the West. In the more likely event that this attempt at economic integration fails as earlier ones have, the US will have more leverage to encourage individual East European regimes to introduce domestic economic reforms that would permit them to reduce trade dependence on the USSR and expand trade with the West. [redacted] 25X1

DISCUSSION

Decentralization of Foreign Trade

Since Gorbachev came to power in 1985, dismantling the state foreign trade monopoly has become the centerpiece of debate on CEMA trade reform. The USSR, Poland, and Hungary have taken cautious steps to relax central control of foreign trade by reducing the power of foreign trade ministries and foreign trade organizations over enterprises. East Germany and Romania, on the other hand, oppose reduction of central control over foreign trade because they believe outside forces will disrupt achievement of domestic economic priorities. [redacted] 25X1

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Countries favoring CEMA trade reforms envision a three-tier system that would play down detailed, long-range planning and political influence in foreign trade. At the top level, the state would only regulate strategic resource allocation in the domestic economy and foreign trade--such as through the phaseout or promotion of specific industries--by a combination of long-range macroeconomic planning and fiscal and monetary policies. The state would continue to control trade in key commodities such as oil or advanced machinery for an indefinite transition period. In the middle, foreign trade ministries and foreign trade organizations would serve enterprises mainly as trade consultants and expediters. The state would delegate actual day-to-day decisions on prices, products to export and import, and cooperative ventures with foreign partners to individual firms that operate on a self-financing basis. Reformers argue that profit-conscious managers of these firms would make the most efficient decisions on what and with whom to trade. 25X1

Decentralization Requires "Direct Links"

Giving enterprises the authority to trade on their own presumes the establishment of "direct links" with enterprises in other CEMA countries. The term is used broadly in CEMA to describe:

- Limited joint ventures between firms in different CEMA member countries for the coproduction of goods or for joint research and development; this category accounts for the vast majority of direct links established so far;

- Multinational joint stock companies formed by complete merger or pooling of some resources to found new firms; these account so far for only a few direct links;

- The untested idea of "multinational cooperatives" which are popular with some market-oriented reformers because cooperatives are less strictly regulated than state-owned enterprises in many Bloc countries. 25X1

CEMA reformers claim that direct links between enterprises will encourage more efficient production through international specializaton and cooperation. When planners control trade, the emphasis is on attaining self-sufficiency in too many industries, and imports are sought only to obtain those goods that cannot be produced in adequate amounts by domestic industry. This fosters duplication of effort, waste, shortages, and stagnation of regional trade. For example, over the past 40 years all East European countries--except Hungary and Bulgaria--developed their own passenger automobile industries despite CEMA plans for a more specialized division of labor. As a result, no one country has been able to produce enough cars efficiently to meet demand, and

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Hungary and Bulgaria are starting up their own industries because their CEMA partners do not produce enough for export. 25X1

Under the new system, enterprise managers would decide on the use of labor, capital, and materials with foreign partners in accordance with cost minimization and profit maximization. Moscow and reform-minded East European regimes hope that this freedom will spur specialization in production and trade on the basis of comparative advantage. 25X1

Obstacles to Direct Links

Several CEMA members have signed bilateral accords to set rules and procedures for establishing direct links between enterprises, but government-to-government agreements have spurred few firm-to-firm contacts. Initial efforts failed because most participating countries had not yet given enterprises the authority to conduct foreign trade. This situation apparently is changing because last year the USSR and several East European countries passed laws that allow state enterprises more autonomy in foreign trade and permit cross-border contracts between private-sector and cooperative firms as well. Romania is the only country that still refuses to allow enterprises to conduct import-export business or coproduction on their own terms with partners in the East or West. 25X1

The new legislation and exhortations from senior leaders have still not sparked much growth in CEMA trade at the firm-to-firm level. Regime reluctance to undertake fundamental economic reforms raises the most important impediment, but numerous political and bureaucratic obstacles also stand in the way. 25X1

The regimes want the gains in efficiency and quality of output that might flow from direct links promoted by market incentives, but they are reluctant to relinguish control over economic decisions and risk the inflation and unemployment that would probably result from the needed reforms. Joint ventures in CEMA will not flourish until the regimes implement coordinated price and currency reforms that give enterprises a basis for calculating costs and potential profits payable in convertible currencies. 25X1 25X1

Mismatched Economic Systems

Despite 40 years of attempts to mesh the Bloc's economies, the dissimilar insitutional mechanisms and largely autarkic orientation of the Soviet and East European economic systems remain major obstacles to the formation of joint ventures. Inconvertible currencies and inconsistent rules and regulations on price formation, asset valuation, capital depreciation, and taxation make doing business on a commercial basis difficult, if not impossible. Bilateral national and CEMA-wide teams of experts are trying to

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consolidate bodies of commercial law, but the East Europeans drag their feet partially out of concern that the establishment of a standard CEMA code could backfire by eliminating loopholes that have helped them moderate Soviet control over their economies. 25X1

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The varying pace of internal economic reform in the region deepens systemic differences and hampers direct links:

o Hungary, Poland, and the USSR are the most vocal advocates of economic reforms and direct links, but they are at odds over measures that would make currency convertibility feasible and provide enterprises a material incentive to establish direct links.

o Czechoslovakia pushes for price and currency reforms in CEMA but fails to implement decentralizing reforms within its own economy. Consequently, Soviet managers now complain about the difficulties of forging direct ties with Czechoslovak counterparts because the latter operate under stricter central controls.

o East Germany touts its 130 direct links with Soviet firms, but it tries to prevent outside interference in its central planning system. Most of these links are really long-standing arrangements brokered at the government-to-government level. East Berlin remains leery of firm-to-firm deals for fear that newly autonomous "self-financing" firms in the more reformist countries will be less dependable in making payments and deliveries. 25X1

Midlevel Bureaucrats Stymie Direct Links

The interest of foreign trade and finance ministries in ensuring balanced trade with soft-currency partners impedes direct links. Opportunities to pool resources and trade goods that seem profitable to enterprise managers have run afoul of traditional CEMA trade rules calling for bilateral trade balance (see box). Government-to-government agreements on CEMA joint ventures state that participating enterprises are free to strike their best deal on goods exchanged or prices charged and can ignore implications for the overall trade balance. The accords provide that intergovernmental trade commisions should adjust for any imbalances resulting from direct links during yearend bargaining over the balancing of national accounts. 25X1

In practice, however, planning, trade, and financial bureaucracies compel cooperating firms to balance the nominal values of traded goods or services to avoid creating surpluses in non-convertible currencies.1 These officials often ignore the trade reforms and prevent implementation of joint venture contracts until the parties pledge to balance the values of their

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transactions. This imperative for balanced trade often forces managers to make irrational economic decisions. For example, firms with direct links that generate surpluses with their partner are reportedly buying back goods totally unrelated to the business venture to consume the surplus. And firms in deficit to their CEMA partners are exporting scarce goods in high demand on the domestic market. 25X1

Lack of Management Experience

Managers of state enterprises in the USSR and Eastern Europe, long accustomed to leaving decisions on products, prices, and foreign trade partners to higher authorities, are reluctant to pursue direct business links with CEMA partners. Their lack of training in business law, foreign trade practices, and foreign languages, among other skills, often makes managers shy away from exercising the greater authority that reform-minded governments may allow. They also lack information about commercial opportunities in CEMA because of limited training and inadequate media for advertising and marketing. Some regimes are beginning to address these problems by promoting contacts between national chambers of commerce and by soliciting Western assistance to set up business education centers, including plans for two such facilities in Moscow and Budapest. 25X1

More Interest in East-West Ventures

Some East European regimes may feel they are in a race with the Soviets and each other to gain edges toward healing their economies by adopting reforms or creating other incentives geared toward more trade with the West. They probably prefer managers to use new foreign trade freedoms to strike deals with Western firms rather than firms in the USSR. At the same time the regimes pledge to promote direct links with CEMA partners, several countries have passed more liberal foreign investment laws designed to attract joint ventures with Western firms, which promise better access to capital and technology and the chance to earn hard currency. Moreover, some East European managers admit that business ventures with Western partners are easier to arrange because they have to deal only with their own country's bureaucracy, rather than with two as is the case in contract negotiations with another East European firm. 25X1

Leaders, Managers At Odds Over Goals

Political leaders and enterprise managers are also at odds over the objectives of joint ventures with Eastern partners. Government leaderships want ventures that will produce new lines of better quality goods and increase trade. However, according to a Polish survey, the few managers who are interested in direct access to a CEMA partner are only shopping for goods to end temporary supply bottlenecks or to substitute soft- for hard-currency imports

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to support production of already established items. As a rule, managers shy away from complex and, in their opinion, risky coproduction agreements in favor of more easily arranged "scientific and technical cooperation." [redacted] 25X1

A Need to Show Results

The desire of Gorbachev and some East European leaders to show quick results for new CEMA initiatives has created pressure to forge direct links even if they are only for show. The mere agreement by two firms to exchange visits or share documentation on research and development activities often satisfies political leaders and raises a country's tally of direct links. Moreover, political bureaucracies, not economic decisionmakers frequently establish specific terms for direct link arrangements. For example, government ministries in Moscow and Warsaw, not enterprise management, drafted the founding statutes of the first dozen Polish-Soviet joint stock companies; only one--a cosmetics venture--actually started operations but is now reportedly running into problems. Protests by Polish firms selected for merger with Soviet entities forced cancellation of plans for ten joint enterprises. This disappointing record has not dampened media publicity for the allegedly "growing" number of Soviet-East European joint ventures. [redacted] the number of direct links in the region now totals around 1,500. [redacted] 25X1 25X1

Soviet Objectives: Political Dimensions

Moscow's rush to set up firm-to-firm ties with Eastern Europe before the necessary domestic economic and CEMA trade reforms are in place suggests that the direct links campaign may serve political goals as much as economic ones. The USSR wants direct links to make intra-CEMA trade more flexible and dynamic, and it wants market reforms to give East European industry incentives to deliver better quality goods. At the same time, Moscow realizes that market-driven integration from the bottom will take a long time and it wants to remain a leader in regional economic development even as more countries go their own ways--with apparent Soviet blessing--in their internal economic and political affairs and in their trade relations with the West. Eastern Europe's dependence on Soviet energy and raw materials remains Moscow's best insurance against a loss of influence, but Gorbachev may also view some integration directed from the top down--in the form of showcase direct links or new multinational institutions founded by intergovernmental agreement--as extra quick fixes to shore up Moscow's leading regional role. [redacted] 25X1

There is some evidence indicating that Moscow is over-anxious to use grass-roots economic integration as a tool to lead the region's opening to the West. Some Soviet economists urge quick action on reforms to make direct links viable in order to ensure that the CEMA economies open up to each other first. They give

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priority to intra-CEMA integration in the belief that CEMA should control its opening to the world economy to minimize risks, such as runaway inflation. They also argue that the region's uncoordinated East-West trade policies--including joint ventures presumably--damage intra-CEMA trade relations, making it all the more urgent to fashion a "socialist common market" as quickly as possible over the next decade. [redacted] 25X1

Ultimately, Moscow wants to replace the top-down command structure of CEMA and state trading with an "organic" network of interdependence at the factory level. The Soviets may believe that the size and proximity of the USSR's economy combined with a network of formal and informal economic ties would secure them sufficient influence over Eastern Europe. This would make it possible to moderate or supplant the more coercive and fraying political integration of party-to-party, state-to-state links, which have not solved problems of declining economic growth and trade or abated East European resentment of the Soviet Union's role as regional leader. [redacted] 25X1

Promoting economic integration with Eastern Europe probably reflects Soviet pursuit of another foreign policy goal. One year after the signing of the EC-CEMA mutual recognition accord, the Soviets are frustrated by EC responses suggesting that the Community does not take CEMA seriously as a multilateral equal. Gorbachev probably wants to cite the spread of direct links and supporting regional institutions in the East as proof that CEMA is following a path of economic integration similar to that of Western Europe's EC-92 integration plans. Moscow will try to use this as grounds for persuading the EC that it should give equal emphasis to dealing with CEMA on substantive international economic issues instead of continuing to focus more on bilateral deals with individual CEMA countries. Moscow hopes that by moving negotiations on East-West economic issues up to the CEMA-EC level, it will strengthen its hand in shaping pan-European relations and its control over Eastern Europe's economic and political relations with the West. [redacted] 25X1

East European Concerns

Eastern Europe probably has much to lose and little to gain from closer links with the Soviet economy, even though many regimes support the initiative out of political expediency. The reservations of most countries stem from concerns that the legal and economic reforms required to make direct links viable--if dictated on Soviet terms--would probably diminish East European control over their domestic and foreign economic policies. Conservative countries such as the GDR and Romania repudiate reforms and direct links, but want to increase or maintain trade with Moscow, but only on existing state-to-state barter terms. Poland and Hungary, on the other hand, support the new approach to CEMA integration in their rhetoric, but their internal reform

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programs are aimed at reducing their economic orientation to the USSR and at achieving a greater Western role in their trade. Some East Europeans hope for improved access to Soviet high technology through direct links, but few believe the Soviets will go far in permitting deals with their most advanced industries dedicated to the military. And East European support for more flexible trade via direct links will not buy what the region wants most--access to more Soviet energy and raw materials on soft currency terms because Moscow will keep strategic trade under central control.

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On the positive side, East Europeans may believe that their endorsement of more East-East joint ventures will ensure Soviet tolerance for their efforts to attract partners in more East-West joint ventures. In recent years, vocal East European support for Soviet-East European integration at the enterprise level has paralleled simultaneous efforts to liberalize joint venture laws to attract Western investment and to conclude bilateral trade accords with the EC. 25X1

Outlook

Moscow's concerns over the slow march toward a "socialist common market" will be keynote themes of bilateral and CEMA-level meetings in the years ahead. Debate will center on how to accelerate change, and some suggested solutions, such as broader price and currency reforms, will probably spark controversy. Nevertheless, Moscow almost certainly will not win the unanimous support needed to give the existing CEMA organization authority to implement these reforms. For this reason, most trade reform experiments will continue to occur outside CEMA in a patchwork of bilateral and trilateral agreements. 25X1

We believe that the USSR will persuade a majority of its East European allies to join it in a quasi-official "rump CEMA"--growing largely out of the many bilateral direct link accords already signed by these countries. This action by majority rule would evade the tradition of unanimity in CEMA decisionmaking and overrule East German and Romanian objections to decentralized trade. The amount of business attributable to direct links will remain small, however, because trade in strategic goods will remain centralized. Nevertheless, current leaders in East Berlin and Bucharest are certain to resent the pressure to hop on the direct integration bandwagon, but the other countries presumably hope that the GDR eventually will fall into line because it is their leading trade partner, particularly in more advanced machinery. 25X1

The key indicator for progress in trade decentralization will be the 1991-95 bilateral trade protocols. In the past, these intergovernmental long-range trade plans and their annual followups have been specific as to quantities, prices, and delivery dates. If enterprises gain more control over trade, the agreements should be less detailed and their importance should decline. However,

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statements calling for closer coordination of national plans during 1991-95 and reports of tough bargaining over the terms of the protocols suggest most regimes remain ambivalent at best about loosening state control over trade. If recent reports on the amount of top-down central direction involved in managing this coordination process are true, we believe that it will be difficult for direct enterprise links and market forces to assert themselves as the motor for regional integration in the 1990s. 25X1

Moscow envisions a CEMA "common market" based on direct links to be largely in place by 2000, but we believe each country will continue to concentrate on pursuing its own economic priorities and policies. For most East European countries this will mean efforts to reduce their dependence on the Soviet market and open up their economies more to world markets. During this period, CEMA or some successor organization will continue to function as a loose political alliance and as nominal coordinator of rules guiding bilateral trade in key commodities such as Soviet energy. East European defense of national interests will prevent CEMA from evolving into an EC-type trading bloc with broad authority over the trade and economic policies of its members. Only if the countries reform their domestic economies first, particularly in the area of price policy, will there be any possibility of progress toward more mutually beneficial forms of integration and increased trade in a regional market. 25X1

Implications for US

Moscow's campaign to foster Soviet-East European economic integration through direct links has implications for US interests in promoting market-oriented reform and greater independence from the USSR in Eastern Europe. On the one hand, the emphasis on decentralization and gradual adoption of market forces is consistent with long-standing US goals for the entire region. On the other, any closer economic integration between Eastern Europe and the USSR that takes place mostly or exclusively on Moscow's terms probably would compromise US interests in increased East European independence. 25X1

Despite its promotion of market reforms, Moscow's advocacy of direct links in CEMA supports other Soviet national interests that would, if achieved, conflict with US goals for Eastern Europe. Moscow stresses the importance of enacting reforms that will allow market forces to drive the process of regional integration, but, increasingly, the Soviets also stress synchronization of reforms and homogenization of policies to make direct links work. This could compromise East European sovereignty and turn direct links into a channel through which Soviet econ omic problems could actually distort market reforms in East European countries and slow their integration into the world economy. Compared to Eastern Europe, Moscow probably will retain more central control over resource allocation in its larger economy

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for a longer period on grounds that it suffers from even worse shortages. The Soviets may then tend to impose their notions of controlled decentralization on coordinated regional economic policies. This would tend to deprive direct links of real market-to-market content and allow central political decisions to undermine commercial ties between Soviet and East European firms. If Moscow succeeds in linking regional integration and reform to the slower march of Soviet domestic reform, it may consolidate its leadership in the area, but CEMA would remain inward-looking longer and face problems meshing as a bloc with the world economy.

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US interests would be better served if, as seems most likely, Moscow's newest strategy fails to revitalize CEMA. In this case, East European countries would be freer to continue reforming their economies at their own pace and on their own terms. Mutual Soviet-East European trade dependence would decrease gradually, even though the two sides would continue to rely on each other in important areas: Eastern Europe on the USSR as a source of energy and raw materials, and the USSR on Eastern Europe for many types of manufactured goods. However, the East Europeans would retain more direct control over their trade with the Soviets because the bulk of it would still be brokered in bilateral, state-to-state channels until the Soviets complete their own reform process. 25X1

Meanwhile, some regimes would probably pursue domestic reforms more vigorously than the USSR in order to open up their economies to the West. Given the political will to follow through on systemic change, countries such as Hungary and Poland will probably become more integrated with the West than East in the next decade. Their economic dependence on the USSR and subordination to Moscow's direction could diminish as they restructure their economies and diversify their trade, and they are likely to become more responsive to Western concerns in many areas ranging from debt repayment to human rights. Those countries that avoid economic reform and involvement with the world economy will see their economies decline further, become less competitive, and forced to subsist off static barter trade with each other. 25X1

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BOX:
A Typical Soviet-Czechoslovak Joint Venture: Old Habits Die Hard

The Prague Compressor Division of the Czechoslovak machine building conglomerate "CKD" and the firm "Kazankompresormash" in Kazan, USSR ran into trouble when they tried to set up a direct joint venture to produce compressors. The firms knew each other through six years of cooperation in R&D information sharing, and reaching agreement in principle without higher mediation was reasonably easy. But the hard part came when they tried to implement their agreement. [redacted] 25X1

This example demonstrates how joint ventures can work at cross-purposes with regime goals for direct links. Enterprises generally seek each other out to solve bottlenecks in supply of inputs, while the regime planners want joint ventures to develop new products for domestic use or for export. The original terms called for CKD-Compressor Division to produce key components for heavy industrial compressors in return for ribbed copper tubing and other materials supplied by the Soviet partner. The arrangement suited the Czechoslovak side because it could avoid the bureaucratic headaches of applying to central authorites for hard currency to import copper tube from its FRG supplier. The Soviet side benefited from finding a partner able to end its shortage of compressor parts. [redacted] 25X1

Unforeseen supply problems caused the first hitch in fulfilling the contract. The Soviet firm found that it could not supply enough copper tube and had to persuade CKD to accept Soviet transmissions to fill the gap. CKD, however, had to redesign the Soviet tranmissions to meet Czechoslovak national standards. CKD's acceptance of the Soviet offer also meant a loss in sales for its traditional domestic supplier of transmissions. [redacted] 25X1

Meanwhile, attempts by the Soviet and Czechoslovak governments to simplify direct trading links actually complicated the deal. The two firms spent a year negotiating the contract, and the terms in "transferable rubles" stated that CKD would supply goods valued at 1,688,000 rubles in exchange for goods from Kazan valued at 261,944 rubles. The lopsided imbalance was not supposed to matter, according to the terms of the Czechoslovak-Soviet joint venture accord, and CKD's hard currency savings more than made up for its ruble loss. Kazan, however, delayed signing the contract for two months until it could clarify whether the joint venture was subject to a March 1988 Czechoslovak-Soviet accord allowing joint venture partners to settle accounts in national currencies instead of transferable rubles. Kazan now claimed that the "direct link" with CKD forced it to insist on the use of Czechoslovak crowns and Soviet domestic rubles in payment for the goods instead of a simple barter exchange recorded in transferable rubles. CKD went along

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still counting on quicker access to Soviet copper tube for soft instead of hard currency. [redacted] 25X1

The Czechoslovak foreign trade ministry, however, introduced further complications into the deal. The ministry informed CKD that it would not allow the firm to run a 1.4 million ruble surplus with Kazan, regardless of its denomination, and that it had to devise a way to balance the account before the deal could go forward. [redacted] 25X1

In the end, CKD had to conclude a deal with Kazan whereby it would import 50 percent of the finished machines built with CKD screw compressor parts to pay off the 1.4 million ruble surplus. Because of the short deadline imposed by the ministry, CKD did not have time to determine if it had any customers for the Soviet product. Now that the contract is sealed, it is doing a market survey but fears that it will be stuck with useless inventory because the Soviet machines probably will not meet Czechoslovak quality standards. [redacted] 25X1

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